IN THE

Supreme Court of the United States

October Term, 1962

No. 78

CHESTER A. PEARLMAN, Trustee,
Petitioner,

vs.

RELIANCE INSURANCE COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT RELIANCE INSURANCE COMPANY

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Statement

The petitioner's statement relates most of the essential facts, but there are a few additional details which we believe should be called to the Court's attention.

The matter was brought on before the referee in bankruptcy by the respondent's petition (pages 2-6 of the Transcript of Record),[1] upon which the referee granted his order to show cause directed to all the bankrupt's creditors (TR 1-2).

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[1] The reference to the Transcript of Record will hereafter be "TR".

Following the return of the order to show cause, the attorney for the trustee—the petitioner herein, and the attorneys for the respondent entered into an Agreed Statement of Facts, which is found at pages 19-25 of the Transcript of Record.

In addition to the matters set forth in petitioner's "Statement of Facts", the following facts were stipulated:

1. There were no appearances by or on behalf of any creditor or interested person, other than the parties to this appeal, who asserted any claim to the $87,737.35 fund here involved (TR 20).

2. That there now remains no known unpaid laborers or materialmen, who furnished labor, materials or services in connection with the Dutcher prime contract (TR 22).

3. That the surety (respondent) paid *claims* under its payment bond, in addition to the sum of $326,248.42, set forth on page 3 of petitioner's brief, the sum of $18,878.47, as required by the Decision of the Court of Appeals for the Second Circuit, in *U. S. v. Fire Association of Philadelphia*, 260 Fed. (2d) 541, and an additional claim of $4,045.92, making a total of *claim payments* of $349,172.81 (TR 22). This is exclusive of attendant expenses paid, amounting to $20,754.34 (TR 21).

4. That the surety-respondent duly made claim to the fund here in question (TR 24-25).

Summary of Argument

The surety-respondent's position is:

1. It took an assignment from the contractor assigning to the respondent, in the event of the contractor failing to pay his bills, all future contract moneys (TR 10-11).

2. It paid all the contractor's bills for labor, materials and services on the contractor's prime contract on the St. Lawrence Seaway, in accordance with its bond obligation entered into contemporaneously with the contract.

The failure of the bankrupt to promptly pay those bills was a "default" on his part.

> *Massachusetts Bonding and Insurance Company v. State of New York*, 259 Fed. (2d) 33, 37-38 (C. A. 2, 1958).

3. That the $87,737.35 fund here in controversy are contract moneys which are the fruit of the labor and material bills which the surety guaranteed to pay and did pay.

4. That by reason of the foregoing, the petitioner is entitled to receive the fund here involved on the following grounds:

   A. By subrogation to the rights of the owner in the contract moneys—the fund here involved.

   B. By subrogation to the rights of the laborers and materialmen whose claims the surety paid.

   C. By direct assignment of the contract moneys by the contractor, long prior to bankruptcy, to the surety.

5. That the bankrupt, at the time of the bankruptcy, had "no property" in the fund here involved, which could pass to its trustee—the petitioner herein.

POINT I

The surety-respondent, pursuant to its obligation under the payment bond, having paid and satisfied the job creditors on the bankrupt's prime contract, became the equitable owner of, and is now entitled to receive, the contract moneys earned by the bankrupt prior to bankruptcy.

The payment bond (TR 15-17) here involved was given pursuant to the provisions of the Miller Act (40 U. S. C. A. 270 ff) in connection with the construction of a portion of the St. Lawrence Seaway, by the Corps of Engineers, on behalf of the United States Government. It obligated both the bankrupt-prime contractor, as principal, and the surety-respondent, as surety, to "promptly make payment to all persons supplying labor and material in the prosecution of the work" (TR 18).

The surety also furnished the required performance bond (TR 15-16).

The appellant, while admitting that the surety would have been entitled to prevail if it had paid out its money *to complete the prime contractor's contract pursuant to its obligations under the performance bond*, urges that because the surety's payments were made *pursuant to its obligations under the payment bond*, it must be relegated to the position of a general creditor, with no special or prior rights to the earned contract moneys—the fund here in question.

We respectfully urge there is no basic difference between the surety's position on a payment bond, as distinguished

from a performance bond. In both instances the surety's money pays for the material and labor going into and forming the improvement, and, in both instances, pays for them pursuant to its obligation and duty so to do under the bonds which it wrote.

The earliest leading performance bond case is *Prairie State National Bank v. U. S.*, 164 U. S. 227 (1896), where the contestants were 1) the contractor's surety who had completed the contractor's contract and 2) an assignee bank. This Court recognized the surety's superior equitable rights and awarded the fund to it.

The leading payment bond case is *Henningsen v. U. S. F. & G. Co.*, 208 U. S. 404, 28 S. Ct. 389 (1908), where the contest was between: 1) a contractor's surety who had paid the contractor's labor and material bills under a payment bond and 2) an assignee bank to whom the contractor had assigned his rights to the contract moneys as security for a loan. Here likewise, this Court recognized the surety's superior equitable rights and awarded the fund to the surety.

During the course of its opinion in the *Henningsen* case this Court, at page 391 of the Supreme Court Reporter said: "*Prairie State National Bank v. U. S.*, (citation) is in point".

THE BASES OF THE SURETY'S RECOVERY

The theories or bases of the surety's recovery have been variously indicated or expressed in the cases. These bases are:

1. Subrogation to the rights of the owner to the contract moneys.

2. Subrogation to the rights of the laborers and materialmen to the contract moneys.

3. Assignment to the surety by the contractor of his rights to the contract moneys.

1. Surety's subrogation to the rights of the owner to the contract moneys.

The rationale here is that the government's statutory requirement that the contractor furnish a payment bond was a recognition of its interest and equitable obligation that the laborers and materialmen be paid. Stemming from this interest and obligation there arose a "right" to use the unpaid contract moneys to pay laborers and materialmen. Consequently, when the surety, under its payment bond, paid the laborers and materialmen, it was subrogated to the rights of the government to the unpaid contract moneys.

An early illustration of the government's concern that suppliers on government jobs be paid is *U. S. v. American Surety Co.*, 200 U. S. 197, 50 L. Ed. 437. The case was decided in 1906, but dealt with events which occurred in 1894 at a time prior to the 1905 Amendment to the Heard Act (August 13, 1894, ch. 280, 28 Stat. 278) and under which the government did not require the "performance" feature of the bond required under the 1905 Amendment (Act of February 24, 1905, ch. 778, 33 Stat. 811).

The 1905 Amendment, when read in the light of the 1894 Act, this Court said at page 202: "* * * shows the consistent purpose of Congress to protect those who furnish labor or material in the prosecution of public work".

The *Prairie State National Bank* case, 164 U. S. 227, (1896) proceeded on the theory that the surety for performance, on completing the defaulting contractor's work, succeeded or became subrogated to the government's rights—for its own protection—in the contract moneys.

In the *Henningsen* case, 208 U. S. 404, 28 S. Ct. 389 (1908) this Court said the *Prairie State Bank* case was "in point" where the surety paid the defaulting contractor's labor and material bills. This would seem to indicate that the surety succeeded or became subrogated to the government's rights—for the protection of laborers and materialmen—in the contract moneys.

We are not unmindful of the explanation of the rationale of the *Henningsen* case, set forth in *Belknap Hardware Co. v. Ohio River Co.*, 271 Fed. 144 (C. A. 6, 1921), which is the one adopted both by the District Court (TR 46) and by the Court of Appeals (TR 55). We shall discuss this ground of recovery shortly.

In other cases the Courts have awarded the contract fund to the surety on the theory of subrogation to the rights of the government to the contract funds.

National Surety Corp. v. U. S., 133 Fed. Supp. 381 (Court of Claims 1955), cert. denied *sub nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181. This was a payment bond case and the surety's adversary was an assignee bank.

In *Continental Casualty Company v. U. S.*, 169 Fed. Supp. 945 (Court of Claims 1959)—a payment bond case, where the surety's adversary was the contractor's trustee in bankruptcy, the Court held that the surety, in paying the contractor's laborers and materialmen, satisfied two (2) obligations of the contractor, 1) to the laborers and materialmen whose bills it paid and 2) to the United States "which was a preferred creditor because of its possession of funds which could be used as an offset against the contractor". The Court then added at page 947:

> "By satisfying the latter obligation, *the plaintiff surety became entitled to be subrogated to the security*

which the United States held, i.e., the funds in its hands" (Emphasis ours).

This is the clearer doctrinal basis as suggested in a well annotated article in 71 Yale Law Journal 1274 (June 1962) entitled "Reconsideration of Subrogation Rights of the Miller Act Payment Bond Surety".

In *Philadelphia National Bank v. McKinlay*, 72 Fed. (2d) 89, (C. A. D. C. 1934) cert. denied, 293 U. S. 583, 55 S. Ct. 96, both the contractor and surety were insolvent. *The government retained the contract fund* pending a decision of the Court. The fund was claimed by the contractor's trustee and the several unpaid materialmen. The Court at page 91 wrote:

> "The obligation of the surety was to pay these debts. *If this obligation had been discharged, the fund now in the hands of the government would belong to it.* * * * *In no case could the fund be considered as due to the bankrupt, and hence to its trustee,* * * *" (Emphasis ours).

To the same effect are:

Morgenthau v. F. & D. Co. of Md., 94 Fed. (2d) 632, 635 (C. A. D. C. 1937);

Massachusetts Bonding & Insurance Company v. State of New York, 259 Fed. (2d) 33, 38 (C. A. 2 1958);

In Re Cummins Constr. Corp., 81 Fed. Supp. 193, 197 (D. C. Md. 1948);

Matter of William P. Bray Company, 127 Fed. Supp. 627, 628 (D. C. Conn. 1954) a non-federal government job;

Danais v. M. DeMatteo Constr. Co., 102 Fed. Supp. 874, 876 (D. C. N. H. 1952) a non-federal government job;

In Re Collins & Kiser Construction Co., 204 Fed. Supp. 42 (D. C. Iowa 1962) an Iowa State Highway Job.

In the case at bar we do not have the situation present in *American Surety Company v. Westinghouse Electric Mfg. Co.*, 296 U. S. 133, 56 S. Ct. 9 (1935), where the surety's bond was not large enough to pay all the job creditors. There the job creditors' rights came ahead of the surety until they received full payment. Here the surety has paid all job creditors. The case illustrates, however, the nature and extent of the materialmen's interest in the contract moneys, to which the surety in the case at bar became fully subrogated, as we shall next discuss.

2. Surety's subrogation to the rights of laborers and materialmen to the contract moneys.

This is the basis for the surety's recovery adopted by the District Court (TR 46) and the Court of Appeals (TR 54-56).

Here the rationale proceeds, in the first instance, as on the first basis previously discussed, *viz.*, the interest or equitable obligation of the government that laborers and materialmen be paid. The statutory payment bond, whether embraced within the combination bond under the 1905 Amendment to the Heard Act (Act of February 24, 1905, ch. 788, 33 Stat. 811) or the separate payment bond under the Miller Act (40 U. S. C. A. 270 ff) did not eliminate or cut down the rights of the laborers or materialmen. Indeed, it gave the laborers and materialmen additional rights—legally enforceable rights under the payment bond required by Congress for their *added protection*. Their equitable rights in the contract moneys continued unabated.

Thus, when the surety under the payment bond paid the laborers and materialmen, it became subrogated to their rights in the contract moneys. This equitable obligation

of the government to see that the materialmen and laborers were paid "* * * would seem sufficient to support the claim of the surety for priority, * * *" (Court of Appeals Opinion TR 56).

In the *Henningsen* case (208 U. S. 404) at page 410, this Court held:

> "It (the surety) paid the laborers and materialmen, and thus released the contractor from his obligations to them, and to the same extent released the government from all equitable obligations to see that the laborers and supplymen were paid. It did this not as a volunteer, but by reason of contract obligations entered into before the commencement of the work".

In *Belknap Hardware & Mfg. Co. v. Ohio River Contract Co.*, 271 Fed. 144 (CA-6 1921) that Court, in spelling out the basis of the surety's recovery in the *Henningsen* case, wrote at pages 148-149:

> "In that case (*Henningsen*), the surety upon a bond of this kind (a payment bond), given pursuant to the 1894 statute, and who had been compelled to pay its surety obligation, was held entitled to priority in the retained fund as against a general creditor of the contractor. * * * The surety's claim of priority in the fund was sustained, and this was done on the stated theory of subrogation. Since there cannot be the transfer of a right by subrogation, unless there is a right to be transferred, we think the necessary effect of the decision is to hold that the laborers and materialmen, in spite of or in addition to the giving of the bond, had an original and continuing equitable priority in the fund, and that it was this right to which the surety was subrogated."

Mechanic's Lien laws are provided for in many of the states and these laws have long been given special recognition by Congress. Section 67 (b) of the Bankruptcy Act, 11 U. S. C. A. 107 (b) provides that a mechanic's lien afforded by state law gives to the mechanic's lienor the

right to file and perfect his mechanic's lien, within the time provided by state law, even though within four (4) months of, or even after, bankruptcy; and that payment thereof shall not constitute a preferential lien or transfer.

In other words, payment from the contract funds, to the extent necessary to satisfy the claim of a laborer's or materialman's mechanic's lien claim does not "deplete" the bankrupt contractor's "estate".

> *Ricotta v. Burns Coal & Building Supply Company*, 264 Fed. (2d) 749 (C. A. 2 1959).

To the same effect are:

> *Albert Pick Co. v. Travis*, 6 Fed. Supp. 486 (D. C. Eastern District of New York 1933);
>
> *In Re Heintzelman Constr. Co.*, 34 Fed. Supp. 109 (D. C. Western District of New York 1940).

In *National Surety Corporation v. United States*, 133 Fed. Supp. 381 (Ct. of Claims 1955), cert. denied *sub nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181, the Court of Claims indicated (page 383) that the rights given to the laborers and materialmen under a Miller Act bond are akin to the mechanic's lien rights afforded suppliers on non-federal construction jobs. In the words of the Court of Claims the United States, "* * * is under no legal liability to pay laborers and materialmen; but it is under an equitable obligation to do so. To discharge this equitable obligation, Congress passed the Miller Act, * * *".

3. Assignment to the surety by the contractor of his rights to the contract moneys.

In many cases the contractor, at the time of his securing the bond or bonds from the surety, executes and delivers to his surety an assignment of all his rights to receive the

contract moneys in the event of a breach of the bond or contract.

Such an assignment is present in this case. It is Exhibit "A" of the surety's petition to have the moneys here in controversy paid to it (TR 6-14). It is stipulated in Item 2 of the Agreed Statement of Facts (TR 19-25 at page 20).

The essential language of the assignment is as follows:

> "* * * the Indemnitors (the bankrupt contractor-principal) do hereby assign, transfer and set over, to the surety * * * such assignment to become effective as of the date of said bond or bonds, but only in the event of any such abandonment, forfeiture or breach as aforesaid—
>
> c. Any and all percentages of the contract price retained on account of said contract, and any and all sums that may be due under said contract at the time of such abandonment, forfeiture or breach, or that thereafter may become due;"

Prior to bankruptcy, on August 30, 1956, the contractor defaulted in the payment of his labor and material bills and the surety in response to its obligations under the payment bond paid \$326,248.42 of such bills. It later also paid other payment bond obligatioins, to bring the total to \$349,172.81, exclusive of expenses of \$20,754.34. (Items 6-9 of Agreed Statement of Facts—TR 21-22.)

It was stipulated that as a result of said payments there remained "* * * no known unpaid laborers of materialmen who furnished labor, materials or services in connection with the Dutcher prime contract" (TR 22).

The rationale of this basis of recovery (not relied upon by either the District Court or the Court of Appeals here) is that the assignment effectively divests the contractor

of any and all rights to the contract moneys operative in the event of a breach of the contract or bond; and, upon such breach, the surety enjoys paramount right and title to the contract moneys.

In *Martin v. National Surety Co.*, 300 U. S. 588, 57 S. Ct. 531 (1937) the lower Court, in a payment bond case, where the contestants were the insolvent contractor's surety and a non-surety assignee, had awarded the fund to the surety as the subrogee of the laborers and materialmen, holding that the assignment was ineffective under 31 U. S. C. A. 203.

This Court held that despite the prohibition against the assignment contained in 31 U. S. C. A. 203, it was valid and enforceable against all persons after the interests of the government had been served. The opinion further pointed out the contractor's failure to pay his bills; that this was a breach of the condition of the bond and held at page 598:

> "The terms of the bond are read into the contract and *there is default under the contract when there is default under the bond*". (Emphasis ours)

This Court, after remarking at page 593 that its decision was being kept "within the necessities of the specific controversy", held that the non-surety assignee received the contract moneys with notice of the surety's rights, and that with such notice, he knew that the contract moneys "* * * became a fund to be devoted in the first instance to the payment of materialmen and others similarly situated" (page 593).

This Court then held at pages 593-594:

> "In our view of the law, the equities in favor of materialmen growing out of that agreement (the assignment) were impressed upon the fund in the possession of the court".

This Court, however, *did not disapprove the basis of the holding of the lower court* in favor of the surety, for in the closing sentence of its opinion, at page 598, it stated:

> "Without denying the possibility of arriving at the same conclusion through over avenues of approach, we follow the pathway that has been marked in this opinion".

Where the interests of the government have not been involved other assignments have been held valid, despite the provisions of 31 U. S. C. A. 203:

> *U. S. v. Aetna Casualty & Surety Co.*, 338 U. S. 366, 70 S. Ct. 207 (1949);
>
> *Lacy v. Maryland Casualty Company*, 32 Fed. (2d) 48 (C. A. 4 1929).

In *U. S. v. Munsey Trust Co.*, 332 U. S. 234, 67 S. Ct. 1599 (1947)—a government set-off case, which we will discuss more in detail later—this Court, in footnote 1 of its opinion, at page 237, in speaking of the contractor's assignment to its surety, said:

> "These assignments were of course invalid against the United States. R. S. Sec. 3477, 31 U. S. C. Sec. 203, 31 U. S. C. A. Sec. 203; *Martin v. National Surety Co.*, 300 U. S. 588, 57 S. Ct. 531, 81 L. Ed. 822, *but they enable the surety to prevail over the contractor if there is contest between them*" (Emphasis ours).

See also:

> *Central Bank v. U. S.*, 345 U. S. 639, 73 S. Ct. 917, (1953) at page 642.

THE MUNSEY TRUST CASE

Following the *Prairie State National Bank* case (164 U. S. 227) in 1896, and the *Henningsen* case (208 U. S. 404) in 1908, there was little or no dispute as to the surety's

paramount rights to the contract balances, in circumstances here present, under either a payment or a performance bond, until this Court's decision in *United States v. Munsey Trust Co.*, 332 U. S. 234, 67 S. Ct. 1599 (1947).

In that case, however, the government was more than a stakeholder. It held contract moneys earned by a contractor on several bonded federal jobs, but the contractor owed the government excess completion costs on an unbonded federal job. This Court permitted the government to set off against the earned contract moneys on the bonded jobs, its loss on the unbonded job.

This Court, after clearly indicating in footnote 1, the surety's superior rights under its assignment where the rights of the government were not involved, and citing *Martin v. National Surety Co., supra* (300 U. S. 588), carefully wrote at page 240:

> "*From Prairie State Nat. Bank of Chicago v. United States*, (citation) to *American Surety Co. v. Sampsel*, (citation) *we have recognized the peculiar equitable claim of those responsible for the physical completion of building contracts to be paid from available moneys ahead of others whose claims come from the advance of money. But in all those cases, the owner was a mere stakeholder and had no rights of its own to assert*" (Emphasis ours).

It is helpful to note that while the surety involved in the *Munsey Trust* case, *supra*, paid bills under its payment bond, this Court, in the quotation above set forth, cited both the *Prairie State National Bank* case (164 U. S. 227), decided in 1896, *which involved a performance bond*, and *American Surety Co. v. Sampsell* (327 U. S. 269), decided in 1946, *which involved a payment bond*. And, of course, included within the time-span of those two (2) decisions was the *Henningsen* case (208 U. S. 404), decided in 1908, which also involved a payment bond.

The principal case relied upon by the trustee in bankruptcy of the contractor is *American Surety Company of New York v. Hinds*, 260 Fed. (2d) 366 (C. A. 10 1958), which professes to find in this Court's decision in the *Munsey Trust* case a repudiation of the doctrine of the *Prairie State National Bank* case (164 U. S. 227) and particularly the *Henningsen* case (208 U. S. 404).

In *National Surety Corp. v. U. S.*, 133 Fed. Supp. 381, (Court of Claims 1955), cert. denied *sub nom. First National Bank in Houston v. U. S.*, 350 U. S. 902, 76 S. Ct. 181, the Court of Claims said at page 383:

> "We reiterate our former opinion that the equity of the surety company is superior to the rights of the bank acquired under an assignment, *whether the surety's rights are derived from the discharge of its liability on a performance bond or on a payment bond.* In *Prairie State Nat. Bank, supra*, the surety had discharged its liability on a performance bond, and in *Henningsen, supra*, its liability on a payment bond" (Emphasis ours).

And at page 384, the Court said:

> "In *United States v. Munsey Trust Co., supra*; the Supreme Court said that the United States was not legally liable to laborers and materialmen, but it did not say that laborers and materialmen could not assert an equitable claim to moneys in the hands of the United States payable under the contract. We think they can".

The Court of Appeals, in the case at bar, in its opinion at page 58 of the Transcript of Record (298 Fed. (2d) 655, at page 659) said:

> "It is inconceivable to us that the Supreme Court intended in *Munsey* to overrule *sub silentio* the rules of priority and subrogation that, as we have already pointed out, were so well established under the Heard Act."

In *Royal Indemnity Co. v. U. S.*, 93 Fed. Supp. 891 (Ct. of Claims 1950) the contest was between the surety on a government contract, who had paid job creditors of a prime contractor *under a payment bond*, and an assignee bank. The government was a mere stakeholder. The surety prevailed.

In commenting on the *Munsey Trust* case (332 U. S. 234) and the views of the several Courts concerning it, including the Court of Appeals of the State of New York, in the *Triborough Bridge* case, 297 N. Y. 31, *Schmoll v. U. S.*, 63 Fed. Supp. 753 (Ct. of Claims, 1946), and *In Re Cummins Constr. Corp.*, 81 Fed. Supp. 193 (D. C. Md. 1948), the Court remarked that in its view the surety's rights had not been cut down by the *Munsey Trust* case, where the government's right of set-off was not involved, and wrote at pages 898-899:

> "It appears that these are correct interpretations of the *Munsey case*. Had the Court there intended to overrule the long line of cases grounded on *Prairie State Bank v. United States*, and *Henningsen v. United States Fidelity & Guaranty Co.*, both *supra*, it is reasonable to assume that they would have been more specifically referred to and discussed. Rather, they are inferentially reaffirmed where applicable facts exist, and the *Munsey* decision limited to its own peculiar facts where the Government's interest is more than that of a stakeholder".

In *Newark Insurance Co. v. U. S.*, 169 Fed. Supp. 955 (Ct. of Claims 1959), the government, after notice from the surety of its rights to the fund, paid the contract moneys to an assignee bank. The surety sued the government for a recovery of the money, and the Court denied the government's motion to dismiss, stating that if the government, with no rights of its own to assert to the fund, and in disregard of the asserted surety's rights, paid the money to the assignee bank, it might have to repay the money.

The government impleaded the assignee bank—Pioneer. The bank then moved to dismiss the government's claim over against it. The Court denied this motion and in its opinion on this branch of the case, 181 Fed. Supp. 246 (1960), wrote at page 248:

> "The Newark Insurance Company as surety was under bond to see that the terms of the contract were carried out. *It had first call on any funds necessary for this purpose.*" (Emphasis ours)

See also:

Gray v. Travelers Ind. Co., 280 Fed. (2d) 549 (C.A. 9 1960).

This paramount right of a surety to contract moneys, where it has paid losses under a payment bond, has been expressly recognized in the following cases, *where the contestant was the trustee in bankruptcy of the contractor:*

Continental Casualty Company v. U. S., 169 Fed. Supp. 945, 946-947 (Ct. of Claims 1959);

Pacific Indemnity Co. v. Grand Avenue State Bank of Dallas, 223 Fed. (2d) 513, 521 (CA 5 1955);

In Re Cummins Constr. Corp., 81 Fed Supp. 193, 196-197 (D. C. Md. 1948).

We respectfully submit that on the ground adopted by the District Court and the Court of Appeals, *viz.*, the surety's subrogation to the rights of the laborers and materialmen, whom it paid, or on the ground of its subrogation to the rights of the government, or upon the assignment given by the contractor, the surety is entitled to recover the fund here in question.

The result reached by the Court of Appeals, in the case at bar, we submit, was clearly right and is not in conflict with, or contrary to, this Court's decision in the *Munsey Trust* case. The views of the Ninth Circuit, in *Phoenix*

Indemnity Co. v. Earle, 218 Fed. (2d) 645 (1955), and those of the Tenth Circuit, in *American Surety Co. of New York v. Hinds*, 260 Fed. (2d) 366 (1958), we submit, have misconstrued, and are in conflict with, this Court's decision in the *Munsey Trust* case.

See in this connection, 71 Yale Law Riview 1274 (June 1962) "Reconsideration of Subrogative Rights of The Miller Act Payment Bond Surety".

In simple justice, the surety who paid for the labor and material bills, which in turn "produced" the fund, is far more equitably entitled to the fund than the trustee in bankruptcy, representing general creditors, who made no direct contribution to producing the fund.

POINT II

The bankrupt had "no property" in the unpaid contract funds here in question and, accordingly, the trustee has no interest or "property" in the $87,737.35 fund.

Under Point I of this brief we have discussed the surety's affirmative rights to the fund here involved. We should now like to briefly discuss the *absence* of the trustee's right to the fund. This is perhaps but the reverse side of the same coin, so to speak, and this Court, along with other Courts, has had, in recent years, this question before it, on several occasions. These cases clearly reveal the absence of any right in the trustee-petitioner to the fund here in suit.

Section 70 of the Bankruptcy Act (11 U. S. C. A. 110) provides that the trustee, upon his appointment and qualification shall, "* * * be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition * * *".

What title did the bankrupt contractor have to the fund here in question? We submit, it had no title to, or property in, the fund whatsoever. It had done certain work, to be sure, but it had also left behind it nearly $350,000.00 of unpaid bills which the surety had to pay and did pay. This was a clear breach of the contractor's obligation to the government under the payment bond which the contractor signed as principal. This in turn was a breach of its construction contract.

> *Martin v. National Surety Co., supra* (300 U. S. 588).

The Second Circuit, in *Fidelity & Deposit Co. v. New York City Housing Authority*, 241 Fed. (2d) 142 (1957) with reference to a public improvement contract with the New York City Housing Authority, held that where the contractor had earned unpaid contract moneys, but owed labor and material bills in excess of the earned but unpaid amount, the contractor had "no property" in those unpaid contract funds to which a federal tax lien against the contractor could attach, citing *United States Fidelity & Guaranty Co. v. Triborough Bridge Authority*, 297 N. Y. 31, 37 (1947).

The *New York City Housing Authority* case, *supra* (241 Fed. (2d) 142) was cited with approval by this Court in *United States v. Bess*, 357 U. S. 51, 55, 78 S. Ct. 1054, 1057 (1958), and also in *United States v. Durham Lumber Co.*, 363 U. S. 522, 526, 80 S. Ct. 1282, 1284 (1960).

In the case last cited, *Durham Lumber* (363 U. S. 522), this Court held that under North Carolina law, and in a factual setting similar to the case at bar, the contractor had "no property" in the fund to which a federal tax lien could attach. And, in *Aquilino v. United States*, 363 U. S.

509, 80 S. Ct. 1277 (1960) this Court held that if, under the New York law, the contractor had "no property" in the contract funds, there was nothing to which the federal tax lien against the contractor could attach. On remand to the New York Court of Appeals of the State of New York, that Court, in 10 N. Y. (2d) 271 (1961) held the contractor had "no property" in the fund.

To the same effect are:

Wolverine Insurance Co. v. Phillips, 165 Fed. Supp. 335 (D. C. Iowa 1958), which involved a private improvement contract in Iowa;

Central Surety & Insurance Corp. v. Martin Infante Co., 272 Fed. (2d) 231 (C. A. 3 1959), which involved a public improvement contract in New Jersey.

It is true that the foregoing cases all deal with property rights, or lack of them, under State law. However, under the federal contract cases we have cited the result would be the same.

In the only case we have found bearing *directly* on this question, *viz.*, *F. Burack Inc. v. Raymar Contracting Corp.*, 32 Misc. (2d) 75, 223 N. Y. S. (2d) 750 (N. Y. 1961), the New York Special Term held that earned contract moneys arising on a federal job situate in New York State, and *where the rights of the United States Government were not involved*, were subject to the trust provisions of the New York Lien Law (Art. 3-A—Lien Law—McKinney's Consolidated Laws).

The situs of the work embraced within the bankrupt's prime contract was New York State (the St. Lawrence Seaway). If resort need be had to New York Law the *Aquilino* case, 363 U. S. 509, and on remand to the Court

of Appeals, 10 N. Y. (2d) 271, would seem to be the complete answer.

In addition, it must be recalled that long prior to bankruptcy the contractor-bankrupt assigned to the surety-respondent, all its rights to the unpaid contract moneys. The assignment became operative the day the bond was executed, *viz.*, April 11, 1955, and accordingly on August 30, 1956, when the contractor became bankrupt, it had "no property" in the contract funds to be passed on to the trustee, the petitioner herein.

The bond was not for the *protection* of the contractor, but rather for the protection of the *contractor's job creditors.* The surety has paid the job creditors. As between the contractor (here represented by the trustee) and the respondent-surety, there are and can be no rights here present *in favor* of the contractor (or the contractor's representative, the trustee) *against the surety.* The obligations run in just the opposite direction—in *favor* of the surety *against the contractor* (and the contractor's representative, the trustee). This is basic in the law of suretyship.

The statutory beneficiaries of the promise made to the United States in the payment bond were the laborers and materialmen of the contractor (bankrupt) on the bonded contract only—*not his general creditors.* Both the trustee and the *amicus* brief of Streeter misconceive this basic relationship.

It must be borne in mind that the trustee expended no money from the bankrupt's estate for the purposes of the prime contract out of which the fund here in issue arose. None of the free assets of the bankrupt's estate have been used for the completion of, or the payment of, labor and ma-

terial bills arising from the prime contract. The trustee and the general creditors represented by him, accordingly, have no equitable claim on the conscience of this Court: they seek only a windfall.

See: 25 Fordham Law Review 241 (1956).

POINT III

The petitioner's brief and the authorities cited therein.

There remains for discussion the petitioner's brief and the authorities cited thereon.

The principal authority relied upon by the trustee is *American Surety Co. of New York v. Hinds*, 260 Fed. (2d) 366 (Tenth Circuit 1958).

In that case the surety's principal was the prime contractor on a Miller act job. The contractor went into bankruptcy.

At that time:

1) 94.86% of the work was completed.
2) $10,145.34 had been earned but was unpaid.
3) Unpaid material bills $15,000.00.

The trustee completed unfinished work at a cost of $994.79.

The government, after various offsets, paid the trustee $7,875.90.

The surety sought an order requiring the trustee to pay over to it the $7,875.90, less the trustee's cost of completing the contract.

Both the District Court and the Tenth Circuit denied surety's application.

The Court's Opinion, at page 368, stated:

1) "Having paid the laborers and materialmen, appellant (surety) may claim subrogation to their rights. But since laborers and materialmen have no enforceable rights against the United States the surety can rise no higher than the basis of the subrogation.

2) It would seem clear that if the surety can claim no enforceable right of subrogation through the creditors paid *and can assert no equitable claim to the fund itself, either in its own right or through the United States*, then the Trustee must here prevail * * *" (Emphasis ours).

We submit that the Tenth Circuit in the *Hinds* case failed to recognize the true equities. Had the surety-respondent not written the payment bond there would have been no source of payment of the labor and material claims. *The fruit of the laborers' and materialmen's efforts created the fund here in question. Had they not expended their labor and materials there would have been no fund to dispose of.* The surety, pursuant to its obligation under the payment bond, paid and discharged those claims—all of them. In equity and simple justice it is entitled to have the fund awarded to it. This consideration, we urge, was completely overlooked or misconceived by the Tenth Circuit in the *Hinds* case.

We respectfully urge that the Tenth Circuit's Decision in the *Hinds* case is contrary to the overwhelming weight of authority and is wrong. It flies in the face of the principle of the *Henningsen* case (208 U. S. 404), and the cases which have followed it. It completely overlooks the principle of law that when the surety pays labor and material bills it becomes subrogated to the rights of the owner to the contract funds. It does, to be sure, become subrogated to the rights of those whose claims it paid; but

that is not all the surety secures by such payment! In addition, it becomes subrogated to the rights of the *owner* to the contract funds! This right is clearly indicated by the *Continental Casualty* case (169 Fed. Supp. 945, and in the *National Surety Corp.* case (133 Fed. Supp. 381), both previously discussed.

It is interesting to note that in the *Hinds* case the Judges were Lewis, who wrote the Opinion, and Judges Bratton and Huxman.

In a later case before the same Court, *viz.*, *U. S. v. Chapman*, 281 Fed. (2d) 862, Judges Bratton, Lewis and Breitenstein sitting, we submit, the doctrine of the *Hinds* case was overruled and repudiated, although the *Hinds* case was never mentioned!

The *Hinds* case proceeds, of necessity, on the theory that the contractor had an interest in the unpaid contract moneys which passed to his trustee in bankruptcy. In this later case by the same Court, the "no property" theory of the other cases we have cited was adopted.

In the *Chapman* case (281 Fed. (2d) 862) one Sims was the general contractor for Bell Telephone Company. Upon *completion of the work* Sims: 1) left unpaid labor and material bills of $20,151.75; 2) made assignments of unpaid contract balances of $11,697.66 to a finance company, as security for loans.

The government held unpaid tax liens of $24,000.00.

The Court, in the *Chapman* case, after referring to *Aquilino v. United States*, 363 U. S. 509, 80 S. Ct. 1277, and *United States v. Durham Lumber Co.*, 363 U. S. 522, 80 S. Ct. 1282, wrote at pages 866-867:

"Sims * * * could not compel the Telephone Company to pay the retained percentage to him because of his failure to pay the laborers and materialmen. * * *

The right to property which the United States asserts is covered by its lien is the right of Sims to compel payment by the Telephone Company. * * * That right does not exist because of the failure to pay the labor and material claims. * * *

As the contractor-taxpayer had no enforceable right to the money covered by the retained percentage, there was no property or right to property to which the tax lien of the United States attached, except to the extent that the retained percentage exceeded the labor and material claims. * * *

Following a long line of federal decisions, Oklahoma has held that *laborers and materialmen have an equitable right to payment from funds due a contractor on a public improvement in preference to general creditors* and that when a surety pays such claims it is *subrogated to the rights of the laborers and materialmen* and its right to recover from the fund takes precedence over an assignment of the fund by the contractor" (Emphasis ours).

The other case relied upon by the petitioner, in addition to those we have already discussed, is *Phoenix Indemnity Co. v. Earle*, 218 Fed. (2d) 645 (Ninth Circuit 1955). In that case the contest over contract moneys was between the surety, who had paid claims under a payment bond of a bankrupt contractor, and a tax lien fully perfected before bankruptcy against the contractor. The Court awarded the fund to the government.

The Court relied upon certain *dictum* of this Court in the *Munsey Trust* case (332 U. S. 234) as is apparent from page 649 of the Court's Opinion.

We respectfully urge that in view of the decisions of this Court in the *Durham Lumber Company* case (363 U. S.

522) and in the *Aquilino* case (363 U. S. 509), the *Phoenix Indemnity* case (218 Fed. (2d) 645) has, in effect, been overruled.

At page 13 of petitioner's brief the case of *Massachusetts Bonding & Insurance Company v. State of New York*, 259 Fed. (2d) 33 (C. A. 2 1958) is cited. That case had two (2) distinct branches—one involved an attempt by the surety to assert the government's priority with respect to a set-off exercised prior to bankruptcy in opposition to a further unpaid federal tax lien sought to be paid out of the bankrupt's *general assets*. The surety was unsuccessful in that branch of the case. The second branch of the case involved *contract moneys* diverted by the bankrupt prior to bankruptcy and invested in real property on which the surety sought to impress a lien prior to bankruptcy, the funds from which finally came into the hands of the trustee as traced funds. Here, the surety was successful.

Petitioner seeks to urge that the portion of the *Massachusetts Bonding* case, *supra*, (259 Fed. (2d) 33) cited, which involved a question of sharing the admitted *general assets* of the bankrupt, is authority in the case at bar, where the *only* fund involved is exclusively earned *contract money*. The two (2) branches of the case are radically different. The first branch is not in point. The second branch of the case fully supports the respondent's position here.

Conclusion

We respectfully urge that the Court of Appeals was clearly right in its determination, tracing, as it did, the surety's rights under the payment bond back to the *Henningsen* case (208 U. S. 404); and that its views that the *Munsey Trust* case (332 U. S. 234), did not cut down or

modify the surety's right in the case at bar, were clearly right.

We respectfully urge that the surety, in the case at bar, by paying *all the claims of the laborers and materialmen*, became subrogated to the rights of the Corps of Engineers (U. S. Government) in and to the fund, which are superior and paramount to any claims of the trustee, representing general creditors of the bankrupt for obligations not connected with the prime contract from which the fund here in issue arose.

We also urge that the surety's position, as subrogee of the claims of the laborers and materialmen, which it paid, comes ahead of the claims of the trustee.

Likewise the surety is entitled to recover by virtue of the assignment.

And, finally, we submit, the trustee has "no property" in the fund whatsoever, both by operation of law and also by virtue of the contractor's assignment to the respondent more than a year prior to bankruptcy.

POINT IV

The determination of the Court of Appeals should be affirmed and the fund ordered turned over to the respondent.

Respectfully submitted,

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I Hereby Certify that I have served a copy of the foregoing brief on Raymond T. Miles, Esq., 942 Ellicott Square, Buffalo 3, New York, petitioner's counsel of record, and John G. Street, Jr., *amicus curiae*, 625 Fort Worth National Bank Building, Fort Worth, Texas, by depositing a copy of the same in a United States mail box, postage prepaid, addressed to each of the above counsel, at the post-office addresses set forth above, on September 12, 1962.

MARK N. TURNER,
Counsel for Respondent.